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IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

No. 614

JOHN C. O'CONNOR, and
THE O'CONNOR PATENT COMPANY,
Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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The O'Connor Patent Company, and John C. O'Connor, respectfully pray that a writ of certiorari issue to review the judgment of the Court of Appeals for the Sixth Circuit entered on October 31, 1958, affirming the decision of the Tax Court entered June 7, 1957 (R. 48; R. 8; R. 9).[1]

Opinions Below

The only opinion of the court below is contained in its Judgment. No printed opinion was filed. The findings of fact, conclusions of law, and decision of the Tax Court (R. 23; R. 7; R. 8; R. 9) are reported at T. C. Memo. 1957-50.

[1] "R" refers to the transcript of record; "C. A." refers to the appendix to the brief filed by John C. O'Connor and The O'Connor Patent Company in the Court of Appeals. "C. A." refers to the appendix to the brief filed by the Commissioner in the Court of Appeals.

Jurisdiction

The court below entered its judgment on October 31, 1938 (*infra*, p. 29). The jurisdiction of this Court is invoked under 28 U. S. C. 1254.

Question Presented

The Constitution gave Congress the power to grant patents on inventions, and the Sixteenth Amendment gave Congress the power to levy excessive taxes (85%) on small incomes ($10,000.00) received under patent licenses, thereby, under the guise of taxation, regulating the flow of invention. Thus a Constitutional guarantee is discouraged by either a doubtful good-faith revenue measure, or a legislative mistake. The question presented is: Is that part of the Internal Revenue Code of 1939 which reads:

> "SEC. 502. PERSONAL HOLDING COMPANY INCOME. For the purposes of this subchapter the term 'Personal Holding Company Income' means the portion of the gross income which consists of:
> (a) * * * royalties * * * ",

repugnant to the Constitution of the United States, Article I, Section 8, Clause 8, and therefore such Act, in-so-far as it applies to royalties paid for the use of patents, not the law of the land?

Constitutional Provisions Involved

Constitution of the United States:

ARTICLE I

Section 8. The Congress shall have Power * * *

* * * * *

To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries;

* * * * *

SIXTEENTH AMENDMENT

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Statutory Provisions

U. S. Code, Title 35, Patents:

Sec. 152. Issue of patent to assignee

Patents may be granted to the assignee of the inventor of record in the Patent Office, upon the application made and the specification sworn to by the inventor, except as otherwise provided in this title. (R. S. 4895; 35 U. S. C., 1946 ed., 44.)

Sec. 153. How issued

Patents shall be issued in the name of the United States of America, under the seal of the Patent Office, and shall be signed by the Commissioner or have his signature placed thereon and attested by an officer of the Patent Office designated by the Commissioner, and shall be recorded in the Patent Office. (R. S. 4883; 35 U. S. C., 1946 ed., 39.)

Sec. 154. Contents and term of patent

Every patent shall contain a short title of the invention and a grant to the patentee, his heirs or assigns, for the term of seventeen years, of the right to exclude others from making, using, or selling the invention throughout the United States, referring to the specification for the particu-

lars thereof. A copy of the specification and drawings shall be annexed to the patent and be a part thereof. (R. S. 4884; 35 U. S. C., 1946 ed., 40.)

Sec. 181. Secrecy of certain inventions and withholding of patent

* * * * *

Sec. 183. Right to compensation

An applicant, his successors, assigns, or legal representatives, whose patent is withheld as herein provided, shall have the right, beginning at the date the applicant is notified that, except for such order, his application is otherwise in condition for allowance, or February 1, 1952, whichever is later, and ending six years after a patent is issued thereon, to apply to the head of any department or agency who caused the order to be issued for compensation for the damage caused by the order of secrecy and/or for the use of the invention by the Government, resulting from his disclosure. The right to compensation for use shall begin on the date of the first use of the invention by the Government. The head of the department or agency is authorized, upon the presentation of a claim, to enter into an agreement with the applicants, his successors, assigns, or legal representatives, in full settlement for the damage and/or use. This settlement agreement shall be conclusive for all purposes not withstanding any other provision of law to the contrary. If full settlement of the claim cannot be effected, the head of the department or agency may award and pay to such applicant, his successors, assigns, or legal representatives, a sum not exceeding 75 per centum of the sum which the head of the department or agency considers just compensation for the damage and/or use. A claimant may bring suit against the United States in the Court of Claims or in the District Court of the United States for the district in which such claimant is a resident for an amount which when added to the award shall constitute just compensation for the damage and/or

use of the invention by the Government. The owner of any patent issued upon an application that was subject to a secrecy order issued pursuant to section 181 of this title, who did not apply for compensation as above provided, shall have the right, after the date of issuance of such patent, to bring suit in the Court of Claims for just compensation for the damage caused by reason of the order of secrecy and/or use by the Government of the invention resulting from his disclosure. The right to compensation for use shall begin on the date of the first use of the invention by the Government. In a suit under the provisions of this section the United States may avail itself of all defenses it may plead in an action under section 1498 of title 28. This section shall not confer a right of action on anyone or his successors, assigns, or legal representatives who, while in the full-time employment or service of the United States, discovered, invented, or developed the invention on which the claim is based. (Act Feb. 1, 1952, ch. 4, sec. 3, 66 Stat. 4; 35 U. S. C., 1946 ed., 153.)

U. S. Code, Other Titles Related to Patents:

42 U. S. C. 2181 (sec. 151). Military Utilization. a. No patent shall hereafter be granted for any invention or discovery which is useful solely in the utilization of special nuclear material or atomic energy in an atomic weapon. Any patent granted for any such invention or discovery is hereby revoked, and just compensation shall be made therefor.

b. No patent hereafter granted shall confer any rights with respect to any invention or discovery to the extent that such invention or discovery is used in the utilization of special nuclear material or atomic energy in atomic weapons. Any rights conferred by any patent heretofore granted for any invention or discovery are hereby revoked to the extent that such invention or discovery is so used, and just compensation shall be made therefor.

c. Any person who has made or hereafter makes any invention or discovery useful (1) in the production or utilization of special nuclear material or atomic energy; (2) in the utilization of special nuclear material in an atomic weapon; or (3) in the utilization of atomic energy in an atomic weapon, shall file with the Commission a report containing a complete description thereof unless such invention or discovery is described in an application for a patent filed with the Commissioner of Patents by such person within the time required for the filing of such report. The report covering any such invention or discovery shall be filed on or before whichever of the following is the later: either the ninetieth day after completion of such invention or discovery; or the ninetieth day after such person first discovers or first has reason to believe that such invention or discovery is useful in such production or utilization.

d. The Commissioner of Patents shall notify the Commission of all applications for patents heretofore or hereafter filed which, in his opinion, disclose inventions or discoveries required to be reported under subsection 151 c, and shall provide the Commission access to all such applications.

42 U. S. C. 2187 (sec. 157). Compensation, Awards, and Royalties. h. PATENT COMPENSATION BOARD.—The Commission shall designate a Patent Compensation Board to consider applications under this section. The members of the Board shall receive a per diem compensation for each day spent in meetings or conferences, and all members shall receive their necessary traveling or other expenses while engaged in the work of the Board. The members of the Board may serve as such without regard to the provisions of sections 281, 283, or 284 of Title 18 of the United States Code, except insofar as such sections may prohibit any such member from receiving compensation in respect of any particular matter which directly involves the Commission or in which the Commission is directly interested.

b. ELIGIBILITY.—

(1) Any owner of a patent licensed under section 158 or subsections 153 b. or 153 c., or any patent licensee thereunder may make application to the Commission for the determination of a reasonable royalty fee in accordance with such procedures as the Commission by regulation may establish.

(2) Any person seeking to obtain the just compensation provided in section 151 shall make application therefor to the Commission in accordance with such procedures as the Commission may by regulation establish.

(3) Any person making any invention or discovery useful in the production or utilization of special nuclear material or atomic energy, who is not entitled to compensation or a royalty therefor under this Act and who has complied with the provisions of section 151 c. hereof may make application to the Commission for, and the Commission may grant, an award. The Commission may also, upon the recommendation of the General Advisory Committee and with the approval of the President, grant an award for any especially meritorious contribution to the development, use, or control of atomic energy.

c. STANDARDS.—

• • • • • •

U. S. Code, Title 26, Internal Revenue Code:

SEC. 500 [as amended by Sec. 181 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed subchapter A net income of every personal holding company (in addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 75 per centum of the amount thereof not in excess of $2,000; plus

(2) 85 per centum of the amount thereof in excess of $2,000.

(26 U. S. C. 1952 ed., Sec. 500.)

SEC. 501. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General Rule.*—For the purposes of this subchapter and chapter 1, the term "personal holding company" means any corporation if—

(1) *Gross income requirement.*—At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 502; but if the corporation is a personal holding company with respect to any taxable year beginning after December 31, 1936, then, for each subsequent taxable year, the minimum percentage shall be 70 per centum in lieu of 80 per centum, until a taxable year during the whole of the last half of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 70 per centum of the gross income is personal holding company income; and

(2) *Stock ownership requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

(b) *Exceptions.*—The term "personal holding company" does not include—

(1) A corporation exempt from taxation under section 101.

(2) A bank as defined in section 104.

(3) A life insurance company.

(4) A surety company.

(5) A foreign personal holding company as defined in section 331.

(6) A licensed personal finance company under State supervision, at least 80 per centum of the gross income of which is lawful interest received from individuals each of whose indebtedness to such company did not at any time during the taxable year exceed $300 in principal amount, if such interest is not payable in advance or compounded and is computed only on unpaid balances.

(7) A loan or investment corporation, a substantial part of the business of which consists of receiving funds not subject to check and evidenced by installment or fully paid certificates of indebtedness or investment, and making loans and discounts, and the loans to a person who is a shareholder in such corporation during such taxable year by or for whom 10 per centum or more in value of its outstanding stock is owned directly or indirectly (including in the case of an individual, stock owned by the members of his family as defined in section 503 (a) (2) outstanding at any time during such year do not exceed $5,000 in principal amount.

(26 U. S. C. 1952 ed., Sec. 501.)

SEC. 502. PERSONAL HOLDING COMPANY INCOME.

For the purposes of this subchapter the term "personal holding company income" means the portion of the gross income which consists of:

(a) Dividends, interest (other than interest constituting rent as defined in subsection (g), royalties (other than mineral, oil or gas royalties), annuities.

(b) Stock and Securities Transactions—Except in the case of regular dealers in stock or securities, gains from the sale or exchange of stock or securities.

(c) Commodities Transactions.—Gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange. This subsection shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

(d) Estates and Trusts.—Amounts includible in computing the net income of the corporation under Supplement E of chapter 1; and gains from the sale or other disposition of any interest in an estate or trust.

(e) Personal Service Contracts.—(1) Amounts received under a contract under which the corporation is to furnish personal services; if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and (2) amounts received from the sale or other disposition of such a contract. This subsection shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform such services.

(f) Use of Corporation Property by Shareholder.—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 per centum or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement.

(g) Rents.—Rents, unless constituting 50 per centum or more of the gross income. For the purposes of this subsection the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under subsection (f).

(h) Mineral, Oil, or Gas Royalties.—Mineral, oil, or gas royalties, unless (1) constituting 50 per centum or more of the gross income, and (2) the deductions allowable under section 23 (a) (relating to expenses) other than compensation for personal services rendered by shareholders, constitute 15 per centum or more of the gross income.

(26 U. S. C. 1952 ed., Sec. 502.)

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as

defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

(b) *Prima Facie Evidence.*—The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders.

(c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond *the reasonable needs of the business shall be determinative* of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

(d) *Definitions.*—As used in this chapter—

(1) *Section 102 net income.*—The term "section 102 net income" means the net income, computed without the benefit of the capital loss carry-over provided in section 117(e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23(s), minus the sum of—

(A) Taxes.—Federal income, war-profits, and excess-profits taxes (other than the tax imposed by

Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) Disallowed Charitable, etc., Contributions.—Contributions or gifts payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in section 23(o), for the purposes therein specified.

(C) Disallowed Losses.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117(d).

(2) *Undistributed section 102 net income.*—The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27(b), but the computation of such credit under section 27(b)(1) shall be made without its reduction by the amount of the credit provided in section 26(a), relating to interest on certain obligations of the United States and Government corporations.

(e) *Tax on Personal Holding Companies.*—

For surtax on personal holding companies, see section 500.

(f) *Income not Placed on Annual Basis.*—Section 47(c) shall not apply in the computation of the tax imposed by this section.

Summary Surtax Rates

SURTAX ON IMPROPERLY ACCUMULATED SURPLUS:

Income Subject to Surtax	Rate of Tax
$ 0–$100,000	27.5%
over–$100,000	38.5%

SURTAX ON UNDISTRIBUTED INCOME OF PERSONAL HOLDING COMPANIES:

Brackets of Undistributed Income	Rate of Tax
$ 0–$2,000	75%
over–$2,000	85%

Statement I.

The findings, conclusions and decisions of the Commissioner of Internal Revenue and the Tax Court.

The Commissioner of Internal Revenue determined deficiencies in Income Tax and Personal Holding Company Surtaxes for The O'Connor Patent Company, for the fiscal years ending July 31, 1950, 1951, 1952 and 1953, in such a way that the sum of these taxes, for each of the fiscal years, exceeded the net income of the Company (Q. A. 3a) as follows:

THE O'CONNOR PATENT COMPANY

Fiscal year ended July 31	1950	1951	1952	1953
Net Income	$5,111.26	$10,808.18	$3,773.13	$6,142.06
Income Tax	1,092.76	2,882.68	1,131.94	1,842.62
Personal Holding Co. Surtax	4,220.88	8,986.96	3,007.16	5,020.75
Total Tax	$5,313.64	$11,869.64	$4,139.10	$6,863.37
% of Net Income	104.0%	109.8%	109.7%	111.7%

The Tax Court in its Decisions reduced the sum of the Income Taxes and Personal Holding Company Surtaxes to a value slightly less than the net income of the Patent Company for the years mentioned (O. A. 8a and 9a) as follows:

THE O'CONNOR PATENT COMPANY

Fiscal year ended July 31	1950	1951	1952	1953
Income Tax	$1,092.76	$ 2,882.68	$1,131.94	$1,842.62
Personal Holding Co. Surtax	3,292.04	6,536.68	2,045.01	3,454.52
Total Tax	$4,384.80	$ 9,419.36	$3,176.95	$5,297.14
% of Net Income	85.8%	87.2%	84.2%	86.2%

The Tax Court had been asked to reduce the personal holding company surtaxes, computed by the Commissioner, to zero, on the grounds that The O'Connor Patent Company was an operating company and not a personal holding company, for several reasons, some of which were based on facts and one of which was based upon law (Constitutional Law). The Constitutional question was put to the Tax Court on brief, and was recognized by that court in these words:

> "The petitioners refer to Article I, Section 8, of the Constitution of the United States which authorizes Congress to secure for a limited time to inventors the exclusive rights to their inventions. They contend that by providing in section 502(a) of the Internal Revenue Code that royalties are personal holding company income and thereby making them subject to the personal holding company surtax imposed by section 500 of the Code and by providing that the surtax shall be in addition to the corporate normal tax otherwise provided in the Code, Congress has imposed a confiscatory tax

on royalties, and in effect has canceled the benefits which the Constitution contemplated should be secured to inventors in their inventions. Accordingly the petitioners ask that we find that the holding company surtax provisions of the Code as applied to the Patent Company during the years in question are violative of Article I, Section 8, of the Constitution" (R-4; O. A.-4a; R-41; CA-19b).

The way in which the Tax Court passed upon the constitutional question appears in the following pertinent quotations.

The Tax Court in its Opinion stated:

a. "* * * by the personal holding company provisions of the Code Congress intended to make it unprofitable for a personal holding company to retain and not distribute its income from royalties from patents, * * *" (O. A. 6a).

b. "* * * although the cumulative effect of the surtax with another tax may be onerous, the surtax is not thereby made confiscatory" (O. A. 6a).

c. The Fifth, "* * * amendment does not require equal treatment in the imposition of taxes" (O. A. 6a).

d. "* * * the Sixteenth Amendment grants unrestricted power to the Congress to lay and collect taxes upon incomes and that the tax imposed by section 351 is upon income" (O. A. 5a).

e. That the, "* * * Intent and effect (*Of Congress to make unprofitable the retention of income from patents*) neither impair the company's rights in its patents nor do they impinge on the security of those rights to the company" (O. A. 6a). Italics ours.

f. After reference to *Commissioner* v. *Lane-Wells*, 321 U. S. 219. Although the gross income, which was material to the holding in that case, was from royalties, the question of the constitutionality of the imposition of the personal holding company surtax was not presented and was not considered by us or the Supreme Court" (O. A. 4a, 5a).

The Tax Court closed the constitutional issue, in its opinion, as follows: "* * * we are unable to find, as petitioners contend, that the personal holding company provisions of the Code as applied to the Patent Company are violative of Article I, Section 8, of the Constitution."

One of the tax reporting services, Commerce Clearing House, Inc., reported the Constitutional opinion of the Tax Court in its "Tax Court Memorandum Decisions" volume 16, page 213 as follows:

[CCH Dec. 22,306(M)] *John C. O'Connor* v. *Commissioner. The O'Connor Patent Company* v. *Commissioner.*

Docket Nos. 55803, 55865, 62052. T. C. Memo. 1957-50. Filed March 28, 1957.

* * * * *

[1939 Code Sec. 502—similar to 1954 Code Sec. 543]

Personal holding company income: Royalties v. compensation: Constitutionality of tax.—Taxpayer corporation, which derived its income from patent licensees, contended that the required percentage of gross income from royalties was not met, because part of the payments received was for engineering services rendered to licensees by taxpayer's controlling stockholder. The court, however, held that the total income was from royalties, since the contracts with the licensees said nothing about services. The court also held that the personal holding company surtax did not

violate the constitutional provision which authorizes Congress to secure to inventors the exclusive rights to their inventions for a limited time.

* * * * *

T.C. Memo. 1957-50—Dec. 22,306(M)

The basis for federal jurisdiction in the Tax Court is that such court has authority to decide an issue of the constitutionality of a provision of federal revenue law involving income taxes, *Commissioner* v. *Independent Life Insurance Co.*, 288 U. S. 592 and *Helvering* v. *Independent Life Insurance Co.*, 292 U. S. 371.

II.

The holding of the court below.

The Judgment of the court below contains the only statement of reasons delivered for giving the Judgment.

The court had the opinion that John C. O'Connor in presenting his petition for review of the decision of the Tax Court held (contrary to his contention) that surtaxes, assessed against his personal holding company were not violative of the constitution (*infra*, p. 29).

> "After due consideration of the oral arguments, the printed briefs, and the record in the cause, we conclude that the decision of the tax court should be affirmed on the basis of its findings of fact and opinion" (*infra*, p. 29).

Judge Charles C. Simons
Judge Florence E. Allen
Judge John D. Martin (R., p. 47).

Opinion, Judge Withey (Tax Court)

An extract of relevant opinion of Court below; Tax Court Memo. 1957-50, "Memorandum Findings of Fact and Opinion," Judge Withey, filed March 28, 1957, comprising text beginning at line 6 page 26, the remainder of page 26, all of page 27, all of page 28, and page 29 to line 9 inclusive:

"The petitioners refer to Article I, Section 8, of the Constitution of the United States which authorizes Congress to secure for a limited time to inventors the exclusive rights to their inventions. They contend that by providing in section 502(a) of the Internal Revenue Code that royalties are personal holding company income and thereby making them subject to the personal holding company surtax imposed by section 500 of the Code and by providing that the surtax shall be in addition to the corporate normal tax otherwise provided in the Code, Congress has imposed a confiscatory tax on royalties, and in effect has canceled the benefits which the Constitution contemplated should be secured to inventors in their inventions. Accordingly the petitioners ask that we find that the holding company surtax provisions of the Code as applied to the Patent Company during the years in question are violative of Article I, Section 8, of the Constitution.

In *Lane-Wells Company*, 43 B. T. A. 463, we held that the taxpayer, more than 80 per cent of whose gross income was from royalties from patents, was a personal holding company and was liable for the personal holding company surtax imposed by the applicable revenue acts. That holding was affirmed by the Supreme Court in *Commissioner v. Lane-Wells Company*, 321 U. S. 219. Although the gross income, which was material to the holdings in that case, was from royalties, the question of the constitutionality

of the imposition of the personal holding company surtax was not presented and was not considered by us or the Supreme Court.

Morris Investment Corporation v. *Commissioner,* 134 F. 2d 774, certiorari denied 320 U. S. 743, involved an appeal from our unpublished opinion in which we held that the taxpayer was a personal holding company and was liable for the personal holding company surtax determined by respondent. In the Circuit Court of Appeals the taxpayer contended that the personal holding company surtax imposed by section 351 of the applicable revenue act was void because it was an attempt by Congress in the guise of a tax to destroy personal holding companies and because the cumulative effect of undistributed profits surtax and personal holding company surtax was confiscatory. In affirming our holding, the Circuit Court of Appeals said:

> "Any discussion as to the validity of this tax must take into account that the Sixteenth Amendment grants unrestricted power to the Congress to lay and collect taxes upon incomes and that the tax imposed by section 351 is upon income. Even if the motive of Congress had been to destroy personal holding companies, as the petitioner contends, the imposition of the surtax was well within the Congressional power to lay taxes upon incomes. * * *"

After observing that the purpose of Congress in imposing personal holding company surtax was to increase the public revenues by making unprofitable the tax avoidance device of retention of income by the personal holding company, the court further said:

> "The Fifth Amendment is not violated by section 351 merely because that section imposes a tax more onerous in the case of personal holding corporations than

other corporations. The amendment does not require equal treatment in the imposition of taxes. Steward Machine Co. v. Davis, 1937, 301 U. S. 548, 584, 57 S. Ct. 883, 81 L. Ed. 1279, 109 A. L. R. 1293. Nor can we find that section 351 amounts to confiscation. Foley Securities Corp. v. Commissioner of Internal Revenue, 6 Cir., 1939, 106 F. 2d 731, 736."

Although it does not appear that the gross income of the Morris Investment Corporation upon which personal holding company surtax was imposed was from royalties from patents, the court has made clear the power of Congress to impose a surtax on the undistributed income of personal holding companies and that, although the cumulative effect of the surtax with another tax may be onerous, the surtax is not thereby made confiscatory. While it is true that the personal holding company surtax imposed on the Patent Company is imposed on the company's undistributed income from royalties from patents, the petitioners have not indicated, nor are we able to see, how that fact in anywise impairs any right which the above-mentioned portion of the Constitution authorized Congress to secure to inventors. Although by the personal holding company provisions of the Code Congress intended to make it unprofitable for a personal holding company to retain and not distribute its income from royalties from patents, and although those provisions do make it unprofitable for the company do do so, such intent and effect neither impair the company's rights in its patents nor do they impinge on the security of those rights to the company. In view of what has been said above, we are unable to find, as petitioners contend, that the personal holding company provisions of the Code as applied to the Patent Company are violative of Article I, Section 8, of the Constitution (R-4); O. A.-4a).

Reasons for Granting the Writ

The decision of the court below, affirming the holding of the tax court, that the personal holding company surtax did not violate the constitutional provision, which authorizes congress to secure to inventors the exclusive right to their inventions for a limited time, will be final in the absence of a Supreme Court review.

1. Importance of the issue

Inventors are granted patents for disclosing their inventions. But these patents are not granted for their own sake. They are granted to help the owner of the patents accomplish something else.

That something else can be to build the patented principles into machines, and enjoy for a limited time royalty in money, in amounts proportional to the value of the contribution of the machine to purchasers.

Now it is WRONG to say that taxing this royalty income 85%, "Neither impair the (owner's) rights in its patents nor do they impinge on the security of those rights to the (owner)" (*supra*, p. 21).

A constitutional guarantee is discouraged either by a doubtful-good-faith revenue measure, or by a genuine legislative mistake. There is a constitutional right to promote the progress of Science and the useful Arts, and excessive taxation can suppress this right.

Is the legitimate taxing power of Congress so enormous that such desirable pursuits as the promotion of new inventions can be stifled by a whim (or mistake) of Congress? It was our understanding that the Constitution was framed to be immune to whims. Is the Sixteenth Amendment to the Constitution the great catch-all provision which enables

the Constitution, " • • • to endure for ages to come, and consequently, to be adapted to the various crises of human affairs". *McCulloch* v. *Maryland*, 4 Wheaton 413.

2. Unwarranted construction in order to save the constitutionality of Section 502 (a) "royalties":

The court below affirmed the construction of the Tax Court judge shown on pages 19 and 20 and 21 *supra*. These were constructions used in prior cases to justify personal holding company surtaxes on incomes other than "royalty income from patents." What makes the same construction inapplicable in the case of patent royalty income is that patents were carved out of the constitution. The great powers of congress are independent powers, great substantive powers, " • • • which cannot be implied as incidental to other powers, or used as a means of executing them." *McCulloch* v. *Maryland*, 4 Wheaton 411.

The Sixteenth Amendment is also a great power, but there is a conflict with the Constitution, when under this Amendment a surtax is drafted which is excessive, and which is used as a means of executing control over one of the best means of promoting inventions. The most appropriate means should not be denied those attempting to employ a constitutional right.

In *McCulloch* v. *Maryland*, 4 Wheaton 406, the Court in discussing implied power of Congress to execute its Constitutional powers by means not spelled out in the Constitution, such as incorporating a branch bank, said "It can never be their (the nations) interest, and cannot be presumed to have been their intention, to clog and embarrass its execution by withholding the most appropriate means."

Men who spend their lives in the world of taxation come to view taxes as the sole motivating reason for certain

actions, such as incorporating a company to promote inventions; hence the unwarranted construction.

3. Conflict in principle:

The question presented poses incentives far beyond the particular facts and parties involved. The Supreme Court approached the problem in *U. S.* v. *Kahriger,* 345 U. S. 35, wherein, "A plan to tax out of existence the professional gambler whom it has been found impossible to prosecute out of existence," was affirmed because, "The evil of a judicial decision impairing the legitimate taxing power by extreme constitutional interpretations might not be transient," 345 U. S. 36.

In the same case, in a dissenting opinion, we read, Congress may make oblique use of the taxing power in relation to activities which Congress may deal directly, as for instance, commerce between the States," 345 U. S. 37. But let us look at the commerce clause, "Congress shall have power . . . to *regulate* commerce . . . etc.," and then at the patent clause, "Congress shall have power . . . to *promote* the progress of Science . . . etc."

"Promote" can in no way be construed to mean "Regulate."

In *Lewis* v. *U. S.,* 348 U. S. 421 we read, "The Federal Government may tax what it also forbids," but from this can we conclude, that because the government forbids personal holding companies, of which there are many kinds depending upon the nature of their income, can it "penalty-tax" them *all* out of existence, even those whose income is obtained from exercising a privilege which the Constitution guarantees? In *Lewis* v. *U. S.,* 348 U. S. at 422 the Court said, "They may have to give up gambling, but there is no Constitutional right to gamble."

Cannot petitioners therefore say: We do not have to give up inventing and promoting our inventions in a corporation having fewer than 5 persons owning 50% of the stock, because there is a Constitutional right to enjoy patents and the income from them, free from oppressive taxes which were designed to stifle the promotion of inventions in closely held companies.

In *Corona Daily Independent* v. *City of Corona,* 346 U. S. 834, we read, with respect to a State privilege tax, that "No government can exact a price for the exercise of a privilege which the Constitution guarantees." This opinion was made in support of a view expressed as, "That is no reason why we should shut our eyes to the nature of the tax and its destructive influence," 346 U. S. 834.

The personal holding company surtax is not the only surtax levied against personal holding companies. They pay the normal fixed rate corporation tax as well as the normal corporation surtax. The Surtax under Section 502 (a) is an additional tax of overwhelming proportions as can be seen in the graph on page (R-3) or in the tables *supra,* pp. 14 and 15. If the Court would hold the issue unconstitutional corporations having royalty income would come under a much less destructive surtax known as "Surtax On Improperly Accumulated Surplus," Section 102 (*supra,* p. 11), or if the surplus could be shown to be properly accumulated, it could, of course be retained in the business.

The personal holding company surtax can also be called unconstitutional, in-so-far as it applies to royalties from patents, because this surtax is said to be *self-executing,* in that there is no discretion in any tax officer. The great substantive powers of Congress " * * * cannot be implied as incidental to other powers, or used as a means of *executing* them." *McCulloch* v. *Maryland,* 4 Wheaton 411.

If we examine all types of income, called personal holding company income, we see that only royalty from patents can be said to have its origin in the Constitution, hence the constitutional issue can be effectively isolated from the nonconstitutional origins of income, namely dividends, rent, interest, annuities, stock and security transactions, commodity transactions, estates and trusts, personal service contracts, and use of corporation property by shareholder.

4. *Practical effect of the disputed decision*:

The consequences of the decision in question on other taxpayers is substantial. If an inventor and *four* other persons own more than 50% of the stock in a corporation which receives mostly royalty income, they pay exorbitant taxes. But if the inventor and *five* other persons own 50% of the stock, the corporation is reasonably taxed as most corporations are taxed.

Now it seems easy to say; just get one more stockholder. But the fact is, that due to the very nature of inventions, and the riskiness of investing in such enterprises, that it is extremely difficult to persuade members of a family much less persons outside of a family, to invest. Also, it is easy to urge 5 persons to invest $100.00, but not easy to convince the same number of invest $10,000.00 each.

By including "royalties" in the definition of personal holding company income, Congress, whether knowingly or unknowingly has struck a severe blow at the rate of invention. Congress has "tax-regulated" that inventors do not form small corporations, from which they might grow. This is especially aimed at independent inventors as contrasted with the "hired" inventors, and discouragement of independent inventors tends to lessen invention. In a book published in 1958, "The Sources of Invention" by John Jewkes, David Sawers and Richard Stillerman, on page

259, in a chapter devoted to "Conclusions" they say, " . . . it seems difficult to avoid the conclusion that high taxation works against the individual inventor."

If the court holds the disputed issue unconstitutional a substantial number of tax cases will be more fairly settled because the "self-executing" characteristics of personal holding company surtaxes will be replaced by the more flexible surtaxes under Section 102; litigation will be reduced.

CONCLUSION

The court below has decided an important question of federal law which has not been, but should be, settled by this court. The petition for a writ of certiorari should therefore be granted.

Respectfully submitted,

JOHN C. O'CONNOR
For Petitioners

December 22, 1958

APPENDIX

Judgment

Nos. 13,433 and 13,434

(Filed October 31, 1958)

In this litigation, the taxpayer, John C. O'Connor, appeared *pro se* in presenting his petition for review of the decision of the Tax Court of the United States, holding (contrary to his contention) that surtaxes, assessed against his personal holding company pursuant to Code provisions, were not violative of Article I, section 8, of the Constitution.

At the hearing of the cause in this court, the Commissioner of Internal Revenue withdrew his cross-petition (No. 13,434).

After due consideration of the oral arguments, the printed briefs, and the record in the cause, we conclude that the decision of the tax court should be affirmed on the basis of its findings of fact and opinion.

It is so ordered (R. p. 48).

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FILED
JAN 26 1959
JAMES R. BROWNING, Clerk

No. 614

In the Supreme Court of the United States

OCTOBER TERM, 1958

JOHN C. O'CONNOR, AND THE O'CONNOR PATENT COMPANY, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. lb-23b) are not reported. The *per curiam* opinion of the Court of Appeals (Pet. 29) is reported at 260 F. 2d 358.

JURISDICTION

The judgment of the Court of Appeals was entered on October 31, 1958. (Pet. 29.) The petition for a writ of certiorari was filed on December 30, 1958. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

QUESTION PRESENTED

Whether the provisions of the Internal Revenue Code of 1939 imposing a personal holding company surtax upon undistributed net income from patent royalties are unconstitutional.

CONSTITUTIONAL PROVISIONS AND STATUTES INVOLVED

The pertinent constitutional provisions and statutes are printed in the Appendix, *infra*, pp. 6-8.

STATEMENT

The relevant facts are undisputed and are set forth in the findings of fact of the Tax Court. (R. 1b-10b.)[1] John C. O'Connor held certain patents covering his inventions, which he transferred to the O'Connor Patent Company. (R. 3b, 6b.) More than fifty percent of the stock of the Patent Company was owned by O'Connor individually (R. 10b), and at least eighty per cent of the gross income of the Company consisted of patent royalties (R. 9b-10b). Accordingly, the Tax Court found that the Patent Company was a personal holding company within the meaning of Section 501(a)(1) of the Internal Revenue Code of 1939, and that its income was personal holding company income subject to the personal holding company surtax. (R. 10b, 16b-17b, 19b-22b). The Court of Appeals affirmed in a *per curiam* opinion. (Pet. 29.)

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[1] A number of issues were litigated in the Tax Court, but all except the question of the constitutionality of the personal holding company surtax as applied to income from patent royalties were abandoned on appeal. The O'Connor Patent Company is the only taxpayer involved in this question, and hence the only proper petitioner here.

ARGUMENT

The decision below, affirming that of the Tax Court, is clearly correct. There is no conflict or other occasion for further review.

The taxpayer corporation's contention that Congress exceeded its constitutional authority to levy taxes (Article I, Section 8, Clause 1, Sixteenth Amendment; Appendix, *infra*, p. 6) by subjecting personal holding companies to surtax on undistributed income derived from patent royalties (Sections 500-502 of the Internal Revenue Code of 1939, Appendix, *infra*, pp. 6-8) is plainly without substance and was properly rejected by both courts below. The contention rests on the novel assumption that the constitutional provision authorizing Congress to grant to authors and inventors exclusive rights in their writings and discoveries (Article I, Section 8, Clause 8: Appendix, *infra*, p. 6), and the implementing statutes, accord special tax immunities to authors, inventors and to corporations to which they assign their statutory rights. There is no basis for this assumption. On the contrary, royalties from patents or copyrights are to be treated, for tax purposes, like other income-producing property. *Fox Film Corp.* v. *Doyal*, 286 U.S. 123, 127-129.

In broadly defining "gross income" as income "derived from any source whatever" (Section 22(a) of the Internal Revenue Code of 1939), Congress intended to exercise "the full measure of its taxing power". *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-430. Income derived from property, consisting of statutory patent rights is no less subject to tax than income derived from other forms of income-producing property. *Fox Film Corp.* v. *Doyal, supra.* Congress unquestionably has the constitutional power to tax

income realized by the inventor himself from the exclusive statutory right to his invention (whether in the form of gain from a sale of the patents or royalties from a license), and from the inception of the income tax laws it has exercised that power without challenge. *A fortiori*, Congress has the power to tax such income in the hands of a corporation to which the inventor has transferred his exclusive rights; and where, as here, the corporation is also a "personal holding company" as defined in the taxing statute, Congress also has the power to impose a surtax on the undistributed portion of its net income. *Commissioner* v. *Lane-Wells Co.*, 321 U.S. 219; *Morris Inv. Corp.* v. *Commissioner*, 134 F. 2d 774 (C.A. 3d), certiorari denied, 320 U.S. 743. As this Court said in *Fox Film Corp.* v. *Doyal*, *supra* (p. 129), "the mere fact that a property right is created by statute to fulfil a governmental purpose does not make it nontaxable when it is held in private ownership, and exercised for private advantage."

The cases with which the taxpayer asserts a "conflict in principle" (Pet. 24-25) involved questions far removed from that presented by this petition, and, indeed, entirely different statutory provisions. To the extent that they have any bearing here, they cast no cloud on the decision below.[2]

---

[2] In *United States* v. *Kahringer*, 345 U.S. 22, and *Lewis* v. *United States*, 348 U.S. 419, the constitutionality of occupational taxes on persons engaged in the gambling business was upheld. *Corona Daily* v. *Corona*, 346 U.S. 833, was a denial of certiorari, the Court refusing to review a decision upholding the constitutionality of a California license tax on the business of publishing a newspaper. The language quoted by taxpayer (Pet. 25) is from the dissent from the denial of certiorari.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
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HARRY BAUM,
JOSEPH KOVNER,
Attorneys.

JANUARY, 1959.

APPENDIX

Constitution of the United States:

ARTICLE I

SECTION 8. The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

* * * * *

To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries;

* * * * *

SIXTEENTH AMENDMENT

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Internal Revenue Code of 1939:

SEC. 500 [as amended by Sec. 181 of the Revenue Act of 1942, c. 619, 56 Stat. 798]. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed subchapter A net income of every personal holding company (in addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 75 per centum of the amount thereof not in excess of $2,000; plus

(2) 85 per centum of the amount thereof in excess of $2,000.

(26 U.S.C. 1952 ed., Sec. 500.)

SEC. 501. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General Rule.*—For the purposes of this subchapter and chapter 1, the term "personal holding company" means any corporation if—

(1) *Gross income requirement.*—At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 502; but if the corporation is a personal holding company with respect to any taxable year beginning after December 31, 1936, then, for each subsequent taxable year, the minimum percentage shall be 70 per centum in lieu of 80 per centum, until a taxable year during the whole of the last half of which the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than 70 per centum of the gross income is personal holding company income; and

(2) *Stock ownership requirement.*—At any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

* * * * * *

(26 U.S.C. 1952 ed., Sec. 501.)

SEC. 502. PERSONAL HOLDING COMPANY INCOME.

For the purposes of this subchapter the term "personal holding company income" means the portion of the gross income which consists of:

(a) Dividends, interest (other than interest constituting rent as defined in subsection (g)), royalties (other than mineral, oil, or gas royalties), annuities.

* * * * *

(g) *Rents.*—Rents, unless constituting 50 per centum or more of the gross income. For the purposes of this subsection the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under subsection (f).

* * * * *

(26 U.S.C. 1952 ed., Sec. 502.)

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